

# Exhibit A



# **Subprime Strategy Working Paper**

*DRAFT*

January 2007



## Framework Intent

- ✓ The purpose of this document is to propose a short-term (12-24 months) strategic plan to be agreed-upon across Freddie Mac and implemented while, at the same time, developing the longer-term *Touch More Loans Strategy*.
- ✓ This document does not advocate that we enter the whole loan subprime business by abandoning our ABS business strategy, but rather prepare ourselves to be competitive in the whole loan space as needed to meet subgoals and business priorities.
- ✓ Agreement on a short-term strategic plan will allow us to move forward while continuing to develop, refine and socialize a longer-term strategy.
- ✓ It will be critical to manage the implementation of this strategic plan to insure movement in the recommended direction, and reap maximum benefits in this space. The strategic plan assumes that a Project Manager will be assigned to this effort to monitor its overall progress.
- ✓ A large part of the long-term *Touch More Loans Strategy* is dependent upon the core capabilities suggested in this strategic plan:
  - o Whole Loan Capabilities;
  - o Aggregation Capabilities; and
  - o Credit Trading Capabilities.



## Findings

### ***The Subprime market is concentrated, however, competition is getting stronger:***

- ***Concentrated and Mostly Wholesale:*** Top 25 account for approximately 90.5 percent of originations – brokers accounted for 59.3% of subprime originations (2005); and 61% (Q1 2006) (see *Appendix B*).
- ***Trend of Expansion into “NonPrime”:*** Given the tightening of the prime market, lenders are expanding their business into the nonprime space to maintain/increase marketshare - Citi combined prime and subprime businesses, Wells has integrated nonprime into their traditional banking, and WAMU combined its prime home-loan and Long Beach Mortgage nonprime units.
- ***Trend of Expansion, by Subprime Lenders, into Prime:*** 15-20% of subprime originations can be considered “prime”. Historically, prime originations by subprime lenders have ranged from 10-15%. Ameriquest’s prime originations are even richer at 25-30%.
- ***The Street has been Purchasing Subprime Lenders:*** Efforts are underway to integrate mortgage origination platforms with securitization desks. Since The Street owns these lenders, they have been investing in making their origination processes better (B&C (Lehman); Mortgage IT (Deutsche Bank)).

### ***Customer Processes are different than what Freddie Mac is used to seeing:***

- ***Customer Processes are Different:*** Subprime processes differ from prime processes (see *Appendix C*) in information requirements, loan origination and servicing. Freddie Mac will need to learn how to work with these practices (managing risk where appropriate) if we are to play in this space.

### ***Fannie Mae is already reaching into this space:***

- ***Fannie Mae:*** Fannie Mae has an EA program and a deeper reach into lower FICOs. Fannie Mae recently announced that it will accept MCM (in flow) with a FICO as low as 500 – potentially reaching into the subprime space. Additionally, Fannie Mae has been more active in pursuing affordable loans at aggressive pricing through the ABS market - although they will most likely purchase 50% of what Freddie Mac purchases this year<sup>2</sup>. *We are also aware that Fannie Mae is making whole loan bids for subgoal purposes (they have the capability to purchase whole loans).*

<sup>1</sup> Inside B&C Lending, April 28, 2006 (Page 3).

<sup>2</sup>Fannie Mae will purchase approximately \$20-30B through ABS, while Freddie Mac will purchase approximately \$60B (Mike Aneiro-2006 estimate).





## Findings (Cont.)

**There is opportunity for Freddie Mac to grow in this space:**

<b>Freddie Mac must</b> 2005 Originations	\$625B	
2005 ABS <sup>1</sup>	\$508B	81%
2005 Conforming Loans (Estimate - % of total originations)	\$500B	80%
Potential "GSE Share" (% of Conforming Loans)	\$400	80%
2005 FRE ABS Purchases (% of Conforming Loans)	\$115B	23%
Potential Incremental Opportunity (Assuming 50% of GSE Share of Conforming Loans)	\$85B	

**The segment is rich in HUD Goals – given how hard it is getting to reach them, look towards growing here:**

2006 Subgoals	HMDA (2005)	FRE ABS (a/o 10/27/06)
Low-Mod (46%)	49.7%	88.4%
Underserved (33%)	54.4%	61.1%
Special Affordable (17%)	20.2%	35.7%
2006 Goals	HMDA (2005)	FRE ABS (a/o 10/27/06)
Low-Mod (53%)	50.8%	62.7%
Underserved (38%)	54.7%	60.1%
Special Affordable (23%)	21.4%	25.8%

**Regulatory decisions will determine the extent of how much opportunity GSE's will be able to take advantage of in this space:**

- **Mostly ARMS:** 52.3% of subprime originations (Q1 2006)
- **Trend Towards More Purchase Volume:** With rates increasing and home values leveling/declining, there is less of a demand towards cash-out refis. Subprime originators are looking at the purchase market to maintain marketshare.
- **Nontraditional Mortgage Underwriting Guidance restricts opportunity in the space:** The majority of subprime loans, such as 2/28 ARMs, don't conform to the nontraditional mortgage underwriting guidance the the Office of Federal Housing Enterprise Oversight recently directed the GSEs to follow.



## Value Proposition – Whole Loan vs. ABS

	Whole Loan	ABS
Pros	<ul style="list-style-type: none"> <li>✓ Supports our Mission – supports additional liquidity in the marketplace as well as assists in minimizing Predatory/Fair Lending Risks.</li> <li>✓ Build reputational capital through HMDA (only tracks whole loan paths).</li> <li>✓ Additional credit for goal purposes (incremental amount depends on Freddie Mac's participation percentage per ABS deal).</li> <li>✓ More customers to purchase product from (subprime and prime lenders – vs. a handful of investment banks) leading to additional share.</li> <li>✓ Creates additional profit potential by eliminating intermediary (investment banks).</li> <li>✓ Gain first look of subprime loans resulting in greater knowledge about the space (as well as a greater selection of what to purchase).</li> </ul>	<ul style="list-style-type: none"> <li>✓ We are currently successful in this space.</li> <li>✓ Can stip for subgoal- qualifying loans.</li> <li>✓ Can take advantage of investment banks' relationships and M&amp;A activity with subprime players.</li> <li>✓ Can choose (and limit) credit risk.</li> </ul>
Cons	<ul style="list-style-type: none"> <li>✓ Potential to cannibalize subprime ABS business by aggravating investment banks (through competition).</li> <li>✓ More credit risk.</li> <li>✓ May be dilutive to goals overall (may not be able to afford goal-rich whole loans).</li> <li>✓ May have less success stippling for subgoal-rich loans in the whole loan space (FNMA has <u>not</u> gone out of its way to stip).</li> </ul>	<ul style="list-style-type: none"> <li>✓ Dependent upon a handful of investment banks (middlemen) to engage with originators.</li> <li>✓ Although we can stip for subgoal-qualifying loans, we are taking the loans that are left after the investment banks skim the most desirable loans from the top.</li> </ul>





## 2007 Subprime Objectives

While continuing to buy ABS, Freddie Mac will position itself to be a buyer of whole loans. In moving down this parallel path, Freddie Mac will pursue the following 2007 Objectives:

	Objective(s)	Target Market
Develop a better understanding around the subprime business.		
Acquire data and learn about processes.	<ul style="list-style-type: none"> <li>• Acquire more comprehensive subprime data; and</li> <li>• Learn about subprime loan manufacturing, operations and loan performance.</li> </ul>	<b>2007:</b> National customers who originate subprime (Chase, HSBC, Wells), and subprime players who have strong subprime origination platforms and controls.
Purchase more investment grade subprime product to learn and gain experience.		
<b>ABS</b> Move down the credit spectrum – $\geq$ BBB	Responsibly buy investment grade product ( $\geq$ BBB) <ul style="list-style-type: none"> <li>• Grow goal-qualifying volume;</li> <li>• Learn about loan performance; and</li> <li>• Position Freddie Mac to take first loss (2008).</li> </ul>	<b>2007 &amp; 2008:</b> Current Customers; Traditional Subprime Originators Selling to Capital Markets (New Century, First Franklin)
<b>T-Deal</b> Leverage additional T-Deal capacity to get subprime whole loans in the door. Learn from them what we can.	Leverage expanded T-Deal capacity in order to buy investment grade subprime product: <ul style="list-style-type: none"> <li>• Wrap investment-grade product (<math>\geq</math>BBB); and</li> <li>• Position Freddie Mac to take first loss (2008).</li> </ul>	<b>2007:</b> National customers who originate subprime (Chase, HSBC, Wells). <b>2008:</b> Subprime players who have strong subprime origination platforms and controls.
Build capabilities and develop strategies to position ourselves for the future.		
<b>Whole Loan</b> Build necessary aggregation/disposition capabilities. Purchase subprime whole loans to support Mission.	Build capabilities (servicing, aggregation, disposition, product paths) needed for subprime (i.e., whole loan, credit trading), supporting the <i>Touch More Loans Strategy</i> . Purchase subprime whole loans for HUD goals (if they fit our current product paths).	<b>2008:</b> National customers originating subprime (Chase, HSBC, Wells). <b>2009:</b> Subprime players who we have relationships with or who have stellar reputations.
<b>PC/ Cash</b> Continue to upstream prime loans from subprime to learn about process. Open up subprime business to a broader segment.	Develop LP Strategy (i.e., sourcing through flow) around Subprime: <ul style="list-style-type: none"> <li>• Upstream prime loans from Subprime originators to learn about the subprime process and loan performance.</li> <li>• Utilize Ameriquest relationship to get a deeper understanding of the data around subprime loans.</li> </ul> Source subprime business from a broader spectrum of lenders.	<b>2007:</b> Ameriquest + 1 additional subprime originator. <b>2008:</b> Subprime players who we have relationships with or who have stellar reputations



## 2007 Tactics Supporting Touch More Loans

*\* Tactics focus on building the appropriate infrastructure and processes to be able to purchase subprime loans while managing our credit risk. Without this infrastructure in place, our credit risk increases. Sourcing Support items provide a guide around approaching this segment of the market.*

	Loan Acquisition/ Sourcing	Loan Servicing	Optimization/ Aggregation	Retention/ Disposition	Security Servicing
Internal Processes	<ul style="list-style-type: none"> <li>✓ Develop Due Diligence and Evaluation Process</li> <li>✓ Develop Understanding of Subprime Loan Manufacturing (i.e., underwriting)</li> </ul>	<ul style="list-style-type: none"> <li>✓ Develop a Monitoring Framework</li> <li>✓ Upgrade Monitoring and Surveillance</li> <li>✓ Implement 99-20 Accounting Treatment</li> <li>✓ Enhance Monitoring and QC Process (2008)</li> </ul>			
Internal Infrastructure	<ul style="list-style-type: none"> <li>✓ Develop Subprime/Prime Model</li> <li>✓ Obtain more Comprehensive Subprime Data</li> </ul>	<ul style="list-style-type: none"> <li>✓ Develop Default Model w/ Subprime &amp; Prime Focus</li> </ul>	<ul style="list-style-type: none"> <li>✓ Build Capabilities Needed for Subprime Whole Loan Aggregation</li> </ul>	<ul style="list-style-type: none"> <li>✓ Build Capabilities Needed for Appropriate Disposition Options for Subprime Loans</li> </ul>	
Subprime Product Paths	<ul style="list-style-type: none"> <li>✓ Build Subprime Product Paths (2008)</li> </ul>				
Sourcing Support	<ul style="list-style-type: none"> <li>✓ Review Subprime Sourcing Incentives</li> <li>✓ Perform Due Diligence on Subprime Origintors</li> <li>✓ Develop Customer Strategy and Education Plan</li> <li>✓ Develop Competitive Response to FNMA</li> <li>✓ Develop LP Strategy around Subprime</li> </ul>				





## 2007 Subprime Tactical Plan

### Infrastructure Support

**\* Key tactics have been identified which need to be developed in order to support the purchase of subprime loans. Identified Officers will be accountable for building a detailed implementation plan around each tactic, as well as executing the plan.**

Timing	Action Plan	Tactics
January-June 2007	Develop Internal Processes to support subprime purchases	<ul style="list-style-type: none"> <li>✓ Develop a Monitoring Framework including – <b>INGRID BECKLES, MICHAEL WADE, DEVAJYOTI GHOSE, MARK PETTIT, GOPAL SHARATHCHANDRA</b> <ul style="list-style-type: none"> <li>• Performance Tracking</li> <li>• Portfolio Management</li> <li>• QC</li> <li>• Servicing Policy</li> <li>• Post-Fund Monitoring</li> </ul> </li> <li>✓ Upgrade monitoring and surveillance (ex: trustee reports) – <b>INGRID BECKLES, MICHAEL WADE</b> <ul style="list-style-type: none"> <li>• Leverage Clayton for deeper surveillance</li> <li>• Develop understanding of subprime projected defaults and severity</li> </ul> </li> <li>✓ Develop Due Diligence and Evaluation Process around subprime loans including: - <b>DON BISENIUS, SHELLEY POLAND, BOB RYAN, GARY KAIN, JAN LUYTJES</b> <ul style="list-style-type: none"> <li>• Policies/Procedures;</li> <li>• Agency Requirements;</li> <li>• Hurdle Rates;</li> <li>• Criteria for taking first loss; and</li> <li>• Risk-Based Capital Thresholds.</li> </ul> </li> <li>✓ Implement 99-20 accounting treatment – <b>TRACY AHERN, TIM ARMSTRONG</b></li> <li>✓ Develop a better understanding of subprime operations and how loans are manufactured (ex: underwriting, QC) - <i>need to build-up resources with subprime servicing knowledge</i> - <b>MICHAEL WADE, SHELLEY POLAND, TRACY MOONEY</b></li> </ul>
January-June 2007	Develop Internal Data to support subprime purchases	<ul style="list-style-type: none"> <li>✓ Obtain more Comprehensive Subprime Data – <b>JOHN STRAKA</b></li> <li>✓ Update Performance Profiles to assist in managing severity – <b>MARTY YOUNG</b></li> </ul>



## 2007 Subprime Tactical Plan

### Infrastructure Support (Cont.)

Timing	Action Plan	Tactics
September 2007- March 2008	Develop Internal Infrastructure to support subprime purchases	<ul style="list-style-type: none"> <li>✓ Develop one model that handles Subprime to be reviewed/approved by ERM – <b>GARY KAIN, JAN LUYTJES, MARTIN YOUNG, EKNATH BELBASE</b> <ul style="list-style-type: none"> <li>• Leverage Blackrock, LPS, Lehman or Andy Davidson's Model(s)</li> <li>• Model for subprime product such as 2/28s, 3/27s, etc.</li> </ul> </li> <li>✓ Develop a default model encompassing subprime – <b>MARTY YOUNG</b> <ul style="list-style-type: none"> <li>• Leverage Early Indicator</li> </ul> </li> </ul>
Q4 2007	Build Subprime Product Paths	<ul style="list-style-type: none"> <li>✓ Build subprime product paths (2/28s, 3/27s) in cash, delivery and servicing – <b>TRICIA MCCLUNG, INGRID BECKLES, KIM PETTY</b></li> </ul>
2008	Enhance Internal Processes to support subprime purchases	<ul style="list-style-type: none"> <li>✓ Enhance our Monitoring and QC Process including: - <b>INGRID BECKLES, MICHAEL WADE, MENNER TATANG, SHELLEY POLAND</b> <ul style="list-style-type: none"> <li>• Trustee Oversight</li> <li>• Servicer Oversight</li> <li>• Higher due diligence standards</li> <li>• Acquire more loan-level data</li> </ul> </li> </ul>



## 2007 Subprime Tactical Plan

### Sourcing Support

Timing	Action Plan	Tactics
January-June 2007	Review Sourcing Incentives	✓ Need to review sourcing incentives around various purchase paths so as not to influence a purchase decision one way or another (ex: T-Deal vs. ABS) – <b>CHARLES COULTER</b>
January-June 2007	Perform due diligence on subprime originators	✓ Utilize operational reviews/audits and other means to determine opinions/rank-order of various subprime originators who we may want to partner with – <b>MICHAEL WADE</b>
3Q 2007	Develop Customer Strategy & Education Plan	✓ Need to develop a customer strategy consistent with the target markets identified for the various purchase paths/capabilities. Additionally, need to develop an approach for speaking to customers about our interest in this space. – <b>CHARLES COULTER, PETER MAHONEY, GARY KAIN</b>
Q1 2007	Outline Competitive Response to FNMA	✓ Outline a competitive response to FNMA - FNMA has announced their intention to create a fixed-rate market in subprime – <b>CHARLES COULTER, TRICIA MCCLUNG, GARY KAIN, BOB RYAN</b>
Q1 2007	Define LP Strategy around Subprime	✓ Define an LP Strategy around subprime product. Consider incorporating S&P Levels. Gain approval and begin implementation – <b>TRICIA MCCLUNG, JAN LUYTJES, CHARLES COULTER, MARTY YOUNG, JOHN STRAKA</b>





## ***Impacts From Freddie Mac Entering the Subprime Whole Loan Market***

<b>Traditional Subprime Lenders (Ameriquest, Option One)</b>	<b>"Full-Spectrum Lenders" Integrating Subprime/Prime into a Continuum of Products (Citi, Wells)</b>	<b>Prime Lenders Diversifying Their Product Base and Expanding Their Risk Appetite (IndyMac)</b>	<b>Freddie Mac</b>
+ Additional Outlet for Products	+ Outlet for More Products + Useful tools (i.e., LP-like tool) supporting origination and minimizing Predatory/Fair Lending risks.	+ Outlet for More Products + Useful tools (i.e., LP-like tool) supporting origination and minimizing Predatory/Fair Lending risks.	+ Contributes to our Public Policy Mission by being able to influence the market through providing liquidity and supporting competition. + Provides additional outlet with which to pursue goal-eligible product (decreases reliance on ABS path and retained portfolio). + Diversifies our overall customer base and supports those existing customers originating subprime product.
- Increased competition from other lenders not traditionally in this space - Overall book of business may be affected by Freddie Mac purchasing premium subprime product.	- Increased credit risk due to the unfamiliarity with handling products they are not used to dealing with. - Enhanced servicing requirements may be more expensive and may require additional expertise that does not exist.	- Increased credit risk due to the unfamiliarity with handling products they are not used to dealing with. - Enhanced servicing requirements may be more expensive and may require additional expertise that does not exist.	- The value proposition of switching from ABS to whole loan is unclear. - As more pressure evolves to align prices with A business (ex: A-Minus), we may not get adequately compensated for the risk we take. - Increased reputational risk: need to focus on those partners engaging in "best practices". - Increased credit/price risk: need to make sure that we adequately understand the risk distribution from prime to subprime and manage accordingly. - Increased marketshare risk: we could become a competitor vs. a partner to the 15 dealers which we work with today.



## Issues/Risks in Implementing a Subprime Strategy

Issue/Risk	Description	Mitigation Tactics	Owner
Increased risk of default	Credit risk tends to be higher with this product vs. Prime product.	Understand the risks associated with this product and be prepared to mitigate them through financial instruments and/or disposition. Have counterparty selection criteria in place in order to carefully select partners with who we conduct business with.	I&CM CCRM
Being able to evaluate underwriting practices which we know little about	Subprime underwriting practices differ from prime practices. Our risk models are based on prime practices.	Mitigate credit risk by supporting the build-out of Whole Loan capabilities (XMC Build-out/credit trading). Understand lenders' processes and "best practices".	I&CM Sales
Predatory Lending and Fair Lending Risk	Need to be cautious of Predatory Lending, as minorities and lower-income/lower credit segments tend to be targeted for these products.	Conduct customer assessments to insure there is no predatory lending activity. Increase intensity around LP Fair Lending testing.	HAR Legal
Potential to be perceived as a threat by some of our traditional lenders in this space	As we become more active in this space, we may influence the market by driving down margins and overall profits in subprime business.	Communicate with our customers about product offerings and our intentions in this space.	Sales Offerings
Loss of business (ABS) by entering the whole loan market.	By entering into the whole loan market, we risk damaging relationships with our dealers, as they will see us as a competitor vs. a partner. We also risk losing ABS business by competing head-to-head with our dealers on whole loans (if dealers choose to retaliate and cut us out of the ABS business they have historically sold to us).	Communicate with our customers about product offerings and our intentions in this space.	I&CM Sales Offerings





## Issues/Risks in Implementing a Subprime Strategy (Cont.)

Issue/Risk	Description	Mitigation Tactics	Owner
Current flow pricing and flow contracting inconsistent with market variability - need to adequately address market pricing.	Freddie Mac follows a traditional Master Agreement approach to flow pricing (i.e., there is a market perception that pricing is locked in for 12 months)	Consider leveraging cash. Write shorter-term contracts.	I&CM
Bulk Process Limitations	We lack adequate capacity and tools to evaluate and price timely subprime deals.	Need to build capability in bulk as well as improve our evaluation tools.	I&CM
We are not set-up to support subprime servicing.	We lack the knowledge and infrastructure to support subprime servicing (particularly in a default situation). Subprime servicing is much more hands-on, and there are process differences from prime servicing.	Need to understand the intricacies of subprime servicing to be able to support purchasing whole loans. Identify and build the necessary infrastructure to support agreed-upon solution.	Performing Loans/ Non-Performing Loans Operations
Counterparty Risk	As the market is mostly sourced by brokers, there is a need to make sure that we have a system in place to manage any counterparty risk.	Become familiar and comfortable with our customers' broker approval processes. Conduct customer/broker assessments on a regular basis. Seek customers with well-established subprime businesses.	Sales EORM





## ***Appendices***

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Appendix B	Subprime Production Channels: 2005-2006
Appendix C	Customer Processes – Subprime vs. Prime
Appendix D	Product Composition and GSE Share
Appendix E	Ameriquist Pilot – Summary
Appendix F	Mortgage Originations by Product
Appendix G	Top 25 B&C Lenders: 2005 & 2006
Appendix H	Top 25 Subprime MBS Originator/Issuers in 2005
Appendix I	Top 25 Subprime MBS GSE Classes in 2005
Appendix J	Top 25 Subprime MBS Originator/Issuers Q1 2006



## **Appendix A**

### **Strategy Development Process**

- ✓ **Interviews:** Gary Kain, Shelly Poland, Connie Ferran, Tim Hartless, Chris Boyle, Julie Groff, Merritt Connell, Paul Iglesias, Phillip Kaupla, Bob Skinner, Mike Konsen, Chris Olson, Ronald Feigles, Rollie Lynn
  - ✓ **Document Review:**
    - *Industry Articles/Presentations/Analyst Reports.*
- 
- ✓ **Need to Get Buy-In on Final Strategy From:**
    - Mortgage Investments and Structuring (Mike A.)
    - Funding and Investor Relations (Mike D.)
    - Mission (Bob T.)
    - Industry Relations (Jeff M.)
    - Housing Outreach (Dwight R.)
    - External Relations (Hollace M.)
    - National Sales (Charles C.)
    - I&CM Strategies/Products (Sam O.)
    - Operations (Ingrid B., Michael W.)
    - Accounting (Tracy A.)
    - Credit (Tracy M.)
    - Credit Risk Management (Shelly P.)
    - CCRM (Don B.)
    - Mortgage Investments and Structuring (Gary K.)
    - Pricing (Bob R.)
    - Single Family Sourcing (Paul M. and Direct's)



## **Appendix B**

### ***Subprime Production Channels: 2001-2005***

